

State of Rhode Island and Providence Plantations
STATE INVESTMENT COMMISSION

Monthly Meeting November 18, 2009

A State Investment Commission (SIC) meeting was held in Room 135, State House, Providence, Rhode Island on Wednesday, November 18, 2009. The Treasurer called the meeting to order at 9:12 a.m.

Membership Roll Call. Present were: Ms. Rosemary Booth Gallogly, Mr. Robert Gaudreau, Mr. Robert Giudici, Mr. Andrew Reilly and General Treasurer Frank T. Caprio. Also present were Ms. Sally Dowling, of Adler, Pollock, and Sheehan and Mr. David Ursillo, of Rodio & Ursillo, Legal Counsel to the Commission; Mr. Allan Emkin and Mr. John Burns of Pension Consulting Alliance (PCA), General Policy Consultants to the Commission; Mr. Nick Katsikis and Ms Lisa Tyrell of State Street Corporation; Mr. Michael Bane of PCG, and Mr. Mark Dingley and other members of the Treasurer's staff. Mr. Michael Costello, Dr. Robert McKenna, Ms. Marcia Reback and Mr. John Treat, were not present.

State Investment Commission Minutes. Treasurer Caprio entertained a motion for approval of the minutes for the meeting of October 28, 2009. Mr. Reilly moved, Mr. Giudici seconded, and the subsequent motion passed. The following members voted in favor: Ms. Rosemary Booth Gallogly, Mr. Robert Gaudreau, Mr. Robert Giudici, Mr. Andrew

Reilly and General Treasurer Frank T. Caprio.

VOTED: To approve the Minutes of the October 28, 2009 monthly meeting.

General Treasurer Caprio introduced Mr. Emkin of PCA.

General Consultant Report. Mr. Emkin stated that he will provide background on hedge funds as the board has decided as part of the strategic asset allocation to look at hedge funds as a possible method to diversify. This presentation is intended to provide a platform for discussion on policy considerations. He pointed out all other vehicles used are long duration and do not use leverage, this very complex vehicle uses short duration and leverage. He asked the group to refer to the handout 'Hedge Fund Investing: Introduction and Implementation Issues'.

He noted hedge funds have been used in the U. S. for sixty years and they can own anything. Institutional investors have played a large role in the growth of hedge funds. The SEC now takes an active role in monitoring the funds. Hedge Funds are not actually an asset class rather they are a contract structure of a business relationship or fee arrangement similar to private equity or real estate.

Mr. Emkin told the group there are various strategies for investing in hedge funds including relative value, event driven and opportunistic. When looking at an industry breakdown by strategy the largest component is equity hedge, which is both long and short, where there

is limited exposure to risk and a lot of exposure to active management skills. He gave a synopsis of hedge funds' characteristics and attributes. The benefit of diversification is that hedge fund performance is not driven by the public markets; however transparency is more limited than the public markets. The fees associated with hedge funds are currently about a 1.5% management and 15 to 20% performance fee.

He stressed a third party expert is strongly advisable. Selecting specific funds is not an area where PCA can advise the board. Mr. Emkin detailed the risks of transparency, leverage and varied rates of return that are associated with hedge funds. He outlined the major reasons in favor and against investing in hedge funds and pointed out that the value added or alpha characteristic is the main reason to invest.

Treasurer Caprio inquired about Mr. Emkin's comment that we do not want an index fund of hedge funds.

Mr. Emkin said you are buying the average of all the players which is zero. In the inefficient markets, private equity, real estate and hedge funds, PCA does not recommend an index fund. This is all about manager selection and PCA has assisted a number of clients select a manager. He noted that none of their clients had exposure to Madoff. Mr. Emkin reviewed industry changes in the last year highlighting pricing, liquidity, transparency and disclosure. He explained the importance of reviewing leverage so that a worst case scenario would have the least impact on outcome.

Mr. Burns added that we talked about hedge fund investing a year or

so ago and decided to wait because of anticipated industry changes. We are seeing these changes now which benefit our position.

Mr. Emkin noted the SEC and legislative bodies have taken a more active role in oversight and regulation of hedge funds. Mr. Emkin stressed that if the board decides to invest in this area, third party expertise is essential. He emphasized risk management, diversification and several other reasons to outsource hedge fund management. Mr. Emkin entertained questions from the group about hedge fund investing.

Mr. Giudici asked why the trend against institutional investing in hedge funds has shifted.

Mr. Emkin asked the group to turn to page five of the handout and commented that today many states have invested in hedge funds. As institutional investing expands, transparency should increase and fees should decrease.

Mr. Goodreau commented that notwithstanding the bad year in 2008, the reason there is so much attention to hedge funds now is this is the space that most strongly does not correlate with the public markets. New regulation and fee reduction make this space more attractive.

Ms. Booth Gallogly said the presentation was very informative, and then expressed some concern over the risks of this type of investment.

Mr. Emkin observed that the short position is tightly managed and there is a long position to balance risk.

Ms. Booth Gallogly asked what the level of risk and diversification is

on other classes in this pool, i.e. commodities.

Mr. Emkin remarked that hedge funds have the most safeguards at the institutional investment level. They have a unique position in the real return portfolio. This makes sense as part of the strategy the board is considering.

Mr. Goodreau commented that “hedge fund” is a broad term and we are looking at the least complex funds that have the most transparency and least risk.

Mr. Emkin suggested the SIC bring in a manager to explain what they do. Until the board members are comfortable, the SIC should not go forward in this area. Today’s goal was to start the education process.

Mr. Giudici asked if there is a typical percentage that a pension fund invests in hedge funds.

Mr. Emkin said we generally tell clients to get to three or four percent in hedge funds for meaningful return.

Mr. Burns stated the real return policy has three to five percent in this space so it will be meaningful.

Mr. Giudici asked about liquidity.

Mr. Emkin stated hedge funds are less liquid than public stocks and bonds but more liquid than real estate and private equity. The issue of liquidity should be managed at the total portfolio level.

Mr. Burns noted that managers understand client needs and build expectations on a worse case scenario.

Mr. Reilly asked who will execute due diligence in manager selection for this class of investment.

Treasurer Caprio said that with advice of PCA there would be a

request for proposals in that area.

Mr. Burns noted the PCA team has experience in manager selection for clients of our size. The discussion regarding hedge funds having concluded, Treasurer Caprio asked for the PCA team to give their thoughts on the portfolio in the current environment.

Mr. Emkin commented that we have had a big rally of late especially in the bond market. The high yield market has almost doubled. There is beginning to be more credit available, but only for those with the best credit rating. The foreign markets, chiefly the emerging markets, have done extremely well, up almost 100% from their bottom. Our advice is to invest in the future, meaning invest in growth. Global growth should be normal over the next 10 years, dominated by growth in the emerging markets. Government debt will be a problem. Inflation will likely come into play when the current debt needs to be repaid. Real estate will continue to be challenged.

The SIC's timing on indexing equities was good. The response to the bond market last year has enabled the fund to recapture almost all losses. The fund should see improvement in private equity. The portfolio has done well relative to its benchmark and its peers. Now is the time to diversify risk.

Legal Counsel Report. Legal Counsel had no report.

Chief Investment Officer Report Mr. Goodreau reported that our performance numbers were very good at October 31, 2009 we are up close to 14% and to date almost 16% for the year. We did exit the

PIMCO portfolio on September 30th with the cash coming into the account in October. Most of the liquidity was equitized through the Russell rebalancing program. Our rebalancing was very timely. For the month of October we beat our benchmark by 8 basis points, excluding private equity. For the year we are beating our benchmark by 80 basis points excluding private equity and real estate.

When we reduced our exposure to active managers, going to a passive mandate, we realized major benefits as evidenced by our rank in the top 5% as of September 30th in all the peer groups State Street monitors in international equity. Fixed income has returned to normalcy.

Ms. Booth Gallogly asked if Wellington Technical Equity is behind benchmark.

Mr. Goodreau replied it was behind but is now above the benchmark; however, looking at the aggregate it is beating the market by about 25%.

Treasurer Caprio asked for a report before the next meeting.

Treasurer's Report. Treasurer Caprio introduced Larry Jillson, a local financial planner. Treasurer Caprio mentioned he is always interested in talking with our local financial leaders. Someone like Larry met with the Treasurer in early 2007 and pointed out some of the issues in securities lending and sub-prime mortgages. Treasurer Caprio provided a few recent articles on securities lending. He mentioned we are not facing the issues raised in these articles. When we fully exited securities lending we profited about \$10 million for the year. He

noted that in one State Street index fund there is still 8% of the portfolio subject to a securities lending program that is winding down. This was in place before we fully indexed. We are monitoring the collateral while we wait for it to mature. Treasurer Caprio said that we have two contracts that are ending; therefore we are going to start the RFP process. PCG is one; Treasurer Caprio met with Mr. Bauer recently to discuss this. First Southwest's contract, our financial advisor for when the state issues debt, is also set to expire. We have notified both parties that we will be issuing RFPs.

Mr. Reilly asked for more information on real estate holdings.

Mr. Goodreau replied he would ask Townsend for a valuations report on real estate for next meeting.

Treasurer Caprio stated we need to address one housekeeping item before we adjourn. He said this month we moved our meeting up a week because of the holiday. He suggested we do the same for December. He asked the members to mark their calendar for December 16, 2009.

New Business. There was no new business.

There being no new business, the Treasurer entertained a motion to adjourn. Mr. Reilly moved, Mr. Giudici seconded and the subsequent motion passed. The following members voted in favor: Ms. Rosemary Booth Gallogly, Mr. Robert Gaudreau, Mr. Robert Giudici, Mr. Andrew Reilly and General Treasurer Frank T. Caprio.

VOTED: To adjourn the meeting.

There being no further business, the meeting was adjourned at 10:29AM.

Respectfully submitted,

**Frank T. Caprio
General Treasurer**